BASEL III FINAL RULES ISSUED

December 20, 2010

To Our Clients and Friends:

The Basel Committee on Banking Supervision (the "Basel Committee") issued its new Basel III framework on December 16, 2010. The new framework is intended to reform the international financial system and improve the banking sector's resiliency in times of financial and economic stress by instituting higher global capital and liquidity standards. This Client Update is intended to alert recipients to this development; a more comprehensive explanation will appear in the January 2011 *Debevoise & Plimpton Financial Institutions Report*.

Overview. The Basel III reforms include higher minimum capital requirements and new conservation and countercyclical buffers, revised risk-based capital measures, and the introduction of a new leverage ratio and two liquidity standards. The new rules will be phased in gradually in an effort to mitigate their potential damage to national economies. On December 17, 2010, a Macroeconomic Assessment Group established by the Basel Committee and the Financial Stability Board issued a final report (the "Final Report") analyzing the macroeconomic impact of the Basel III reforms over the transition period, which concludes that the Basel III capital standards are likely to have "a relatively modest impact on growth."[1]

Capital. Basel III will require banks to maintain: (i) a minimum common equity capital ratio of 4.5%, (ii) a minimum Tier 1 capital ratio of 6% and (iii) a minimum total capital ratio of 8%. The minimum common equity ratio will ensure that banks maintain more core capital, consisting predominantly of common shares and retained earnings, than currently. In addition to the minimum capital requirements, Basel III will require a "capital conservation buffer" of 2.5%. As a result, if a bank does not have common equity, Tier 1 and total capital ratios of at least 7%, 8.5% and 10.5%, respectively, its ability to pay dividends and discretionary bonuses or engage in share repurchases will be limited. In addition to the capital conservation buffer, each national regulator is given discretion to institute a "countercyclical buffer" if it perceives a greater system-wide risk to the banking system as the result of a build-up of excess credit growth in its jurisdiction. This countercyclical buffer, if implemented, would (like the capital conservation buffer) restrict discretionary distributions, and require retention of up to an additional 2.5% of risk weighted assets, resulting in

[1] *Macroeconomic Assessment Group, "Final Report: Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements" (Dec. 2010, available at http://www.bis.org/press/p101217.htm.)*

minimum common equity, Tier 1 and total capital ratios of up to 8.5%, 11% and 13%, respectively.

As to timing, the three basic minimum capital requirements will be phased in first, with a longer period for compliance with the capital conservation buffer and other requirements. Under the new standards, by January 1, 2013, banks would need to meet a 3.5% common equity capital ratio, which will increase in annual fifty basis point increments to 4.5% by the beginning of 2015; Tier 1 capital requirements will increase from 4.5% to 6% over the same period. The minimum total capital ratio remains unchanged at 8%. Beginning January 1, 2016, the capital conservation buffer will add 0.625% to the three basic ratios, and then increase by 0.625% each year until it reaches the maximum of 2.5% in January 2019. The phase-in of deductions from capital that qualifies as common equity (*e.g.*, for investments in financial institutions, mortgage servicing rights and deferred tax assets) will proceed by 20% annual increments beginning in January 2014. Moreover, while the definition of common equity will be set as of January 2013, the removal of instruments that no longer qualify as non-common equity-based Tier 1 or Tier 2 capital will be phased in over a ten year period horizon beginning in 2013.

Basel III also introduces a new leverage ratio requirement intended to constrain what the Basel Committee perceives to be both excessive on- and off-balance sheet leverage in the banking sector. On-balance sheet items to be included for purposes of the leverage ratio include repurchase agreements, securities financing transactions and derivatives; off-balance sheet items include commitments (including liquidity facilities), unconditionally cancellable commitments (at a credit conversion factor of 10%), direct credit substitutes, acceptances, standby letters of credit, trade letters of credit, failed transactions and unsettled securities. A supervisory monitoring period will begin in 2011, a parallel testing run of a minimum Tier 1 leverage ratio of 3% will begin in 2013, and any adjustments are contemplated to be made before full implementation of the leverage ratio requirement on January 1, 2018. Basel III would require banks to disclose their leverage ratio and its components beginning January 1, 2015.

In addition to raising the quality of capital and level of the capital base, Basel III aims to improve risk coverage by reforming the treatment of counterparty credit risk ("CCR"), which is the risk that a counterparty to a transaction could default before the final settlement of the transaction's cash flows. Going forward, affected banks generally will: (i) be required to determine their capital requirement for CCR using stressed inputs, (ii) be subject to a capital charge for potential mark-to-market losses associated with counterparties' deteriorating credit-worthiness, (iii) have to apply longer margining periods to determine their capital requirements with respect to large and illiquid derivative exposures, and (iv) be incentivized to move collateral and mark-to-market exposures to central counterparties, among other reforms intended to raise CCR management standards.

Liquidity. On the liquidity side, Basel III implements the standards proposed in the Basel Committee's December 2009 liquidity proposals: the liquidity coverage ratio (the "LCR") and the net stable funding ratio (the "NSFR"). The LCR is a standard intended to promote short-term resilience to potential liquidity disruptions over a thirty day horizon. The LCR will require affected banks to maintain sufficient high-quality liquid assets to cover 100% of the net cash outflows that could be encountered under an acute stress scenario assuming (i) a significant downgrade of the bank's credit rating, (ii) a partial loss of deposits, (iii) a loss of unsecured wholesale funding, (iv) a significant increase in secured funding haircuts, and (v) increases in derivative collateral calls and substantial calls on off-balance sheet exposures. Expected inflows eligible for netting against outflows will be capped at a maximum of 75% of expected outflows.

The NSFR, which seeks to change more structurally a bank's balance sheet in terms of liquidity, establishes a minimum amount of stable funding a bank will be required to maintain based on the liquidity of the bank's assets and activities over a one year time horizon. The ratio of available stable funding to the amount of required stable funding must be greater than 100%.

Basel III provides for an observation period to begin in 2011, during which the Basel Committee will monitor the implications of the standards for financial markets, credit extension and economic growth, addressing unintended consequences as necessary, including by revising specific components of the standards. It is contemplated that the LCR and the NSFR, including any revisions, will be introduced as minimum standards beginning January 1, 2015, and January 1, 2018, respectively.

Systemically Important Financial Institutions. Both the Basel Committee and U.S. regulators are developing rules to address risks posed to the financial system and the economy as a whole by systemically important financial institutions. Basel III indicates that the Basel Committee will continue its work to determine (i) qualitative and quantitative factors to assess the systemic importance of financial institutions at a global level, and (ii) how best to mitigate systemic risk. Measures the Basel Committee is considering with respect to systemically important financial institutions include additional capital surcharges, contingent capital and bail-in debt. In the United States, the Dodd-Frank Act tasks the Financial Stability Oversight Council and the Federal Reserve with identifying and imposing heightened prudential standards on systemically important financial institutions.

Implementation of the Basel III Standards. The fact that the Basel Committee has completed its work does not mean that banks now have final rules with which they must immediately comply. The Basel III directives are not self-effectuating but, rather, must be adopted by legislation or regulation to be imposed on any particular country's home banks.

—In the United States. As to the United States, it is worth remembering that U.S. banking regulators promoted the development of Basel II before proceeding to only partially implement those final rules (compelling only the largest and most internationally active U.S. banks to adopt the Basel II advanced approach). This past September, U.S. bank regulators issued a joint statement specifically stating support for the Basel Committee's efforts "to strengthen the position of large and internationally active banks." That statement, combined with the fact that historically Basel Committee capital directives often have applied more broadly to European banks than U.S. banks, raises a question as to whether, like Basel II, only a subset of the largest U.S. banks will be subject to Basel III. There has been, however, some informal indication by the Federal Reserve that Basel III, at least in some form, will apply more broadly to U.S. depository institutions. Significant questions also remain as to how the mandates of the Dodd-Frank Act for systemically significant banks to meet enhanced capital, liquidity and other requirements will be integrated with the requirements of Basel III.

—In Europe. As part of the implementation of Basel III into EU law across all 27 EU Member States, the European commission has proposed amendments to the EU Capital Requirements Directive ("CRD IV"). This will be the third amendment to the Capital Requirements Directive in two years, reflecting the fast pace of legislative developments at the EU level as European legislators and regulators try to ensure that the recent financial crisis is not repeated. In order to become law across the 27 Member States of the EU, the EU Commission's proposed amendments will not only have to be agreed by the Council of the EU and the European Parliament but will also have to be implemented into national law by the EU Member States. Of concern as to that effort, in October, the European Parliament raised several issues with a number of elements of the Basel Committee proposals, including that a "'one size fits all approach' could stifle economic recovery." UK banks have historically maintained higher minimum capital ratios than other European banks and are therefore likely to be well placed to ensure compliance with Basel III.

Please feel free to contact us with any questions.

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